SHELL OFFSHORE INC.

IBLA 88-109 Decided October 17, 1990

Appeal from a decision of the Director, Minerals Management Service, affirming an order to recalculate royalties and pay such additional amounts as are owing. MMS 87-0037-OCS.

Reversed in part and affirmed as modified in part.

1. Administrative Procedure: Administrative Record

When a notice of appeal to the Board of Land Appeals from a decision of the Director, MMS, is filed, MMS is required to submit the complete, original case file, containing all documents relating to the dispute at hand.

2. Rules of Practice: Appeals: Dismissal--Rules of Practice: Appeals: Statement of Reasons

A statement of reasons for an appeal that does not point out affirmatively why the decision appealed from is in error does not meet the requirements of the Department's rules of practice and may be dismissed. Conclusory allegations of error, standing alone, do not suffice to point out error.

3. Administrative Procedure: Rulemaking--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

The "Procedure Paper on Natural Gas Liquid Products Valuation," developed by MMS, is not a substantive regulation subject to the rulemaking requirements of the Administrative Procedure Act, 5 U.S.C. § 553(b) (1988).

4. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Since, unless otherwise expressly provided, all royalty payments are accepted subject to audit, a subsequent determination that additional royalties are due does not give rise to a question of retroactive application of a new rule if the determination that a deficiency exists was made under the regulation applicable at the time that the payment was originally made.

5. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where it is MMS policy to accept the Department of Energy ceiling prices for natural gas liquid products as representing fair market value for royalty purposes in certain instances, and MMS has followed that policy in a number of cases, its refusal in another case to accept those ceiling prices in favor of the monthly average spot market prices must be deemed arbitrary and capricious.

6. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where an oil and gas lessee sells natural gas liquid products pursuant to a non-arm's-length contract at a price below the "yardstick" valuation as derived from the "Procedure Paper on Natural Gas Liquid Products Valuation," royalty is properly assessed at the "yardstick" valuation unless the lessee can affirmatively show that its non-arm's-length contract had characteristics similar to arm's-length contracts entered into at the same time, in the same general area, and for the same product.

7. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where a floor price was established generally for natural gas liquid product valuation for royalty calculation, royalty could not be assessed using a higher rate than the floor price.

APPEARANCES: Judith Y. Robertson, Esq., New Orleans, Louisiana, for appellant; Peter J. Schaumberg, Esq. Geoffrey Heath, Esq., Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Shell Offshore Inc. (Shell) has appealed from a decision of the Director, Minerals Management Service (MMS), dated September 29, 1987.
This decision affirmed a December 12, 1986, decision of the Regional

Manager, Tulsa Regional Compliance Office (TRCO), Royalty Management Pro-gram (RMP), directing Shell to recalculate royalties due on natural gas liquid products (NGLP's) produced under certain Outer Continental Shelf (OCS) leases 1/ and processed at the Grand Chenier Processing Plant (Grand Chenier) during the period from October 1977 through September 1981.

This is one of a number of appeals which the Board has reviewed concerning production processed at Grand Chenier. See, e.g., Cities Service Oil & Gas Corp., 113 IBLA 255 (1990); Conoco Inc., 110 IBLA 232 (1989). Grand Chenier is operated by Conoco Inc., on behalf of itself and nine other major owners, including Shell. In February 1984, an audit of royalties paid on NGLP's processed at Grand Chenier was conducted by the Office of Inspector General, Department of the Interior, which concluded that various underpayments had occurred and made various recommendations regarding corrective measures which should be undertaken. Thereafter, MMS conducted its own review.

On December 12, 1986, the Regional Manager, TRCO, issued an order detailing the results of the MMS review and specifying various revisions which should have been made in computing royalties. Included in these revisions, inter alia, were changes to the manufacturing allowance, adjustments to gross liquid production figures, and, of particular importance to the instant appeal, instructions that royalty for NGLP's should be recomputed in accordance with the "Procedure Paper on Natural Gas Liquid Products Valuation" (Procedure Paper), utilizing the monthly average Mont Belvieu spot market price for non-arm's-length transactions when the value reported by Shell for determining royalty was below the low Mont Belvieu price for that month.

Shell appealed this order to the Director, MMS, arguing generally that the Procedure Paper constituted an invalid promulgation of a rule in violation of the provisions of the Administrative Procedure Act (APA), 5 U.S.C. § 553 (1988), that the new procedures delineated in the Procedure Paper represented an inequitable departure from past practice sanctioned by MMS, and that, even granting the validity of the Procedure Paper, MMS had failed to follow its provisions by not affording appellant an opportunity to demon-strate that its non-arm's-length contracts represent fair market value. Additionally, with respect to non-ethane NGLP's, Shell noted that, during much of the period for which a recalculation of royalties had been ordered, it had based its royalty payments on the maximum allowable price under Department of Energy (DOE) regulations, and that "[t]he prices quoted by MMS in this assessment as being reflective of market value include the recoupment of refining pass-through costs allowed Shell under the [DOE] regulations," contending that MMS was assessing royalty based on prices higher than Shell could have lawfully collected.

By decision dated September 29, 1987, the Director, MMS, affirmed the order of the Regional Manager, TRCO. In his decision, the Director

1/ The leases involved are OCS-G 0406, OCS-G 0407, OCS-G 2825, OCS-G 3293.

rejected appellant's assertions that the Procedure Paper constituted improper rulemaking and countenanced retroactive application of a new rule to appellant's detriment (Decision at 6-7). The Director also noted that appellant had failed to introduce any evidence which would establish its contention that its non-arm's-length contracts had characteristics similar to arm's-length contracts (Decision at 8). Finally, in response to the assertion by appellant that, with respect to non-ethane NGLP's, it had tendered royalty based on the highest lawful ceiling price allowed under DOE regulations, the Director noted:

> Shell was allowed to sell price controlled NGLP based on their adjusted May 15, 1973, selling price and increased costs pursuant to 10 CFR part 212 Subpart K (1981); however, it was required to determine its maximum lawful selling prices pursuant to Subpart E. Section 212.83(c)(1)(ii)(A) of Subpart E (1981) entitled "General Refinery Products" provided:
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>> In apportioning the total amount of increased costs allocable to general refinery products among particular general refinery products, a refiner may apportion amounts of increased costs to a particular product in whatever amounts it deems appropriate * * *.
>
> Inasmuch as Appellant controlled the allocation of increased costs to determine the DOE maximum allowable price, RMP did not consider the prices used by Appellant to be the "maximum allowable price." Thus, the yardstick values could properly be applied.

(Decision at 8). Shell thereupon took the instant appeal to this Board.

[1] Before considering the issues presented in this appeal, we are constrained to comment on two aspects of this case which we find unsatis-factory. First of all, as we have had cause to note in the past, the state of the records transmitted to the Board by MMS leaves much to be desired. See, e.g., Shell Offshore, Inc., 113 IBLA 226, 97 I.D. 73 (1990); Dugan Production Corp., 103 IBLA 362 (1988); Mobil Oil Exploration & Producing Southeast, Inc., 90 IBLA 173 (1986). In particular, we wish to advert to the presence in the record of xeroxed copies of documents which refer to attachments not in the record. As an example, the original decision by the Regional Manager, TRCO, referred to a total of eight exhibits, none of which were included in the file. We assume that these documents were not available to the Director, MMS, in his review either.

While the case file is adequate for the purposes of our consideration of the matters pressed in this appeal, we must again admonish MMS that it is obliged to submit "the complete, original administrative record to this Board, including all original documentation involved in the matter." Dugan Production Corp., supra at 364. This includes all documents and exhibits referenced in the original decision. A similar failure to provide the complete record in the future may again result in the inability of the Board to affirm MMS decisions quite apart from their ultimate substantive cor-rectness. See Shell Offshore, Inc., supra.

[2] The second point which we wish to make concerns the adequacy of appellant's statement of reasons submitted in support of its appeal. Save for the addition of one paragraph concerning the issue of the valuation of non-ethane NGLP's, the statement of reasons before the Board is a verbatim replication of the statement of reasons submitted to the Director, MMS. This is so despite the fact that the Director's decision addressed each argument which appellant presented below.

The Board has noted many times that "the failure on appeal to point out affirmatively why the decision appealed from is in error may be treated in the same manner as an appeal in which no statement of reasons has been filed." United States v. De Fisher, 92 IBLA 226 (1986), and cases cited. In this regard, we would point out that, before the Board, the decision under review is not the decision of the Regional Manager, TRCO, but rather the decision of the Director, MMS. Appellant has, as a general matter, not attempted to address any of the holdings in the Director's decision. Rather, it has merely reiterated the arguments considered by the Director, as if there were no Director's decision addressing those points. It seems clear that, in accord with our precedents, this appeal is subject to summary dismissal. However, inasmuch as our prior analyses of the Procedure Paper have disclosed certain flaws in the application of the "yardstick" valuation method employed herein, we deem dismissal inappropriate.

As we noted at the outset of this opinion, the propriety and application of the Procedure Paper have been the subject of numerous recent decisions by this Board. In Cities Service Oil & Gas Corp., supra, we briefly described the portions of the Procedure Paper relevant to the consideration of the instant appeal:

> [T]he Procedure Paper is designed to assure that proper royalties are tendered on NGLP production. To effectuate this intent, the Procedure Paper set out to develop what it referred to as a "'yardstick' valuation technique" (Procedure Paper at 3). The Procedure Paper noted that a review of various factors such as the NGLP sales contracts, prices received by lessees, Table 7 (DOE) prices, and commercially available NGLP bulletins, had led to the conclusion that the price bulletins represented the best available price source and would, in most instances, be indicative of NGLP fair market value (Procedure Paper at 5). Accordingly, use of three bulletins were recommended. The "yardstick" price was to be derived by using the highest and lowest prices for each month from the appropriate bulletin. Any reported value falling within this range would be within the "yardstick" valuation. If the reported value was below the range of values for a specific month, the average value of the "yardstick" for that month would be the minimum value accepted by MMS (Procedure Paper at 6-7). [Footnote omitted.]

Id. at 257-58.

It must also be noted, however, that while the Procedure Paper provided for development of a "yardstick" valuation, this "yardstick" valuation was applied in limited circumstances. Thus, if an arm's-length contract existed, the Procedure Paper provided that the contract price would normally be con-sidered to establish fair market value, unless actual proceeds were higher. Of particular note for the instant appeal, the Procedure Paper also provided that if, during the period in which NGLP prices were controlled by DOE reg-ulations, a lessee received a maximum permissible price under the DOE reg-ulations, the price actually received would be accepted as fair market value, even though it might be less than the "yardstick" price. The applica-bility of this latter provision is examined later in the text of this opinion.

[3] Appellant's generalized objections to MMS' use of the Procedure Paper are quickly disposed of. With respect to appellant's assertion that the adoption of the Procedure Paper constituted improper rulemaking in derogation of the provisions of 30 CFR 206.150 (1987), 2/ we noted in Amoco Production Co., 112 IBLA 77 (1989), that:

> In fact, the Procedure Paper itself relies on the factors set forth in the regulation--the lessee's price, regulated prices, posted prices, and gross proceeds. It provides guidance by specifying which of the factors listed in 30 CFR 250.64 (1982) is to be given the most weight in various circumstances. * * *.

Id. at 81. Similarly, in Conoco Inc., supra at 242-43, we held that:

> The Procedure Paper merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees. It did not require lessees to value their production by any specific method, nor did it modify any existing regulation. Rather, it found that, after consideration of the factors listed in the regulations, the best measurement of the reasonable value of NGLP in situations where no arm's-length contract existed was the commercially available spot price bulletins. We find the Procedure Paper to be essentially a policy guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation. As such, it does not have the force and

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2/ The general valuation regulation applicable herein was originally pro-mulgated in 1954 and codified as 30 CFR 250.64. See 19 FR 2659 (May 8, 1954). Its language was revised in 1979 (see 44 FR 61892 (Oct. 26, 1979)), and it was redesignated as 30 CFR 206.150 in 1983. See 48 FR 35641 (Aug. 5, 1983). In Transco Exploration Co., 110 IBLA 282, 317 n.24, 96 I.D. 387, 386 n.24 (1989), the Board noted its view that the substance of the regu-lations had remained substantially the same throughout this period. However, the royalty valuation regulations were substantially revised in 1988. See 53 FR 1272 (Jan. 15, 1988). The instant appeal is being decided under the regulations applicable at the time the royalty was due.

> effect of law as a duly promulgated regulation does, and the Board will decline to follow it where it is inconsistent with the terms of the relevant regulations.

Consistent with our past holdings, we reject appellant's assertion that the Procedure Paper constitutes a substantive rule of law adopted in violation of the applicable provisions of the APA. Rather, the Procedure Paper merely establishes internal guidelines to be used in implementing the relevant regulatory and statutory mandates. Accord Cities Service Oil & Gas Corp., supra; Amoco Production Co., supra; Conoco Inc., supra,

[4] In addition, to the extent that appellant's argument concerning retroactive application of a new rule is premised on the contention that the Procedure Paper constitutes a substantive rule of law, this contention also must fail. Nor does the initial MMS acceptance of its payments compel a different result. In the absence of an express statement to the contrary, "all royalty payments are accepted subject to audit and the 'silent acceptance of royalty when initially tendered does not constitute an express determination of the proper royalty level.'" Cities Service Oil & Gas Corp., supra at 260, citing Supron Energy Corp., 55 IBLA 318, 321 (1981).

Thus, the mere fact that appellant valued its production under one method and submitted royalty based on this valuation does not give an appellant a right to insist on the acceptance of its valuation method. As we noted in Cities Service Oil & Gas Corp., supra,

> where Government acceptance of the tender of royalties is made subject to post audit, the mere recomputation of the royalty payments due to the Government to correctly reflect fair market value of NGLP's does not constitute imposition of a penalty or give rise to an issue of retroactive application of a new rule. [Footnote omitted.]

Id. at 261. Ultimately, therefore, the only real question involved in this appeal is whether or not the decision of the Director, MMS, requiring recomputation of the royalty due was based on procedures which would correctly ascertain fair market value. We turn now to this question.

Appellant bases its objection to the MMS instruction that it recompute the royalty due for NGLP's on two separate grounds. First, it argues that, for the period of time in which DOE price controls were in effect i.e., prior to January 1980 (February 1981 for propane), the prices it utilized in valuing non-ethane NGLP's were the maximum prices allowable under DOE regulations and, thus, even under the Procedure Paper, it was proper to use these prices. Second, appellant argues that it was not afforded an oppor-tunity to show that its non-arm's-length contracts represented fair market value. We will explore these two questions seriatim.

[5] The essence of MMS' position with respect to non-ethane NGLP's during the period of DOE control is that since, under 10 CFR 212.83(c)(ii) (1980), appellant, as a refiner, was permitted to allocate increased product costs (which would be recoverable via an increase in maximum permissible

pricing under 10 CFR 212.161) "to a particular general refinery product in whatever amounts it deems appropriate," the maximum price under which it valued NGLP's should not necessarily be considered the maximum permissible price under DOE regulations. MMS argues that appellant had it within its power to so allocate any increased product costs (and, thereby, raise the maximum permissible price) to any particular refinery product as it saw fit and, therefore, the prices which it asserts were the maximum permissible prices under DOE regulations may not, in point of fact, have been the maximum prices allowable.

Initially, we note that there is nothing in the record submitted to the Board to indicate that appellant did, in fact, allocate such increased product costs in a manner designed to lower its royalty payments. In any event, in Phillips Petroleum Co., 109 IBLA 4 (1989), a panel of this Board held that a similar refusal to accept DOE ceiling prices as representing fair market value must be deemed arbitrary and capricious, given the instructions of the Procedure Paper. 3/ Accordingly, to the extent that the deci-sion below instructed appellant to recompute the value of non-ethane NGLP's during the period in which these products were subject to DOE price controls, the decision must be reversed.

[6] There remains, however, the issue of the proper valuation of ethane as well as the non-ethane NGLP's during the period after DOE price controls ended. We note that appellant has argued that it was not afforded an opportunity to show that its non-arm's-length contracts represent fair market value in violation of the provisions of the Procedure Paper. We do not agree. In the first place, contrary to appellant's assertion on appeal, the Procedure Paper does not afford appellant an opportunity to show that its non-arm's-length contracts represent fair market value. Rather, the Procedure Paper affords an opportunity to a lessee to show that its non-arm's-length contract "has characteristics similar to arm's-length contracts which represent fair market value" (Procedure Paper at II.B.2.(b)(i)). This is an important distinction, as we shall explain.

As noted above, the Procedure Paper first derived a "yardstick" value to determine a range for fair market value. So long as the valuation for royalty purposes was above the minimum "yardstick" price MMS did not chal-lenge the valuation unless gross proceeds were in excess of those reported. Even where the reported value was below the "yardstick" minimum, the Proce-dure Paper did not automatically apply the "yardstick" value. Rather, the Procedure Paper provided that where a lessee was able to show that it had valued its production on the basis of prices received under an arm's-length contract, MMS would normally accept that valuation, even though it was below the fair market value as derived from the "yardstick" range.

3/ In a memorandum dated May 28, 1987, which accompanied the transmission of the case files to the Director, MMS, the Regional Manager, TRCO, argued that the Director's decision in MMS-85-107-O&G supported his decision to utilize the "yardstick" prices. This decision was reversed in Phillips Petroleum Co., supra.

It is not difficult to discern the underlying basis for this approach. Spot market prices for petroleum products are, by their very nature, sub-ject to rapid and immediate fluctuation, as the past few months dramatically attest. It is in an attempt to apportion the risk inherent in such volatility that buyers and sellers often enter into fixed term contractual arrangements committing themselves to buy and to sell the commodity in question at a pre-set price. An inevitable result of these arrangements is that, over the con-tract term, the pre-set price may be less than the spot market price at some times and, at other times, be greater than the spot market price.

The Procedure Paper eschews any general attempt to penalize those who have entered into arm's-length agreements when there has been an upward movement in the spot market price, recognizing, correctly, that while at a point in time the price received may be below the spot market price, this does not mean that the total contract remuneration was not fair market value when entered into. The linchpin for this approach is the assumption that the agreed-upon contract terms are the result of negotiations between par-ties intent upon maximizing their own economic return. Because the parties to the contract had opposing economic interests i.e., the seller seeking to maximize return and the buyer seeking to minimize costs, there is at least a reasonable likelihood that the contract terms eventually adopted represented fair market value, given all of the variables which were negotiated. Thus, even where the price received under an arm's-length contract is below the "yardstick" price range for a specific month, MMS will normally accept the contract price for the purpose of royalty valuation. 4/

Where, however, affiliated or interrelated companies are dealing with each other, the same economic realities may not obtain. This is particu-larly true, as we noted in Transco Exploration Co., 110 IBLA 282, 96 I.D. 367 (1989), when royalty payments come into play. By lowering the price used for calculating the royalty it is quite possible to increase the total economic return to the affiliated companies at the expense of the royalty interest owner. This is easily done by shifting profits from the producing side which pays royalties to the resale or distribution side which does not. Recognizing this reality, the Board has consistently held that where a con-tract is between affiliates or subsidiaries "there must be independent indicia establishing that the contract price is one fairly derived from the marketplace." Transco Exploration Co., supra at 322, 96 I.D. at 389. See also AMAX Lead Company of Missouri, 84 IBLA 102 (1984); Getty Oil Co., 51 IBLA 47 (1980).

4/ There may be situations in which MMS would be justified in ignoring an arm's-length contract price. In Transco Exploration Co., supra, the Board noted that an oil and gas lessee has an obligation to employ reasonable business judgment in fulfilling its implied obligation to exercise good faith in the marketing of petroleum products. Id. at 326-27, 96 I.D. at 391. Thus, if the terms of a contract are so one-sided that it cannot be deemed the product of reasonable business judgment, MMS would be within its authority to ignore the contract price and insist on valuation of the Government's royalty interest on the basis of the "yardstick" value.

The provisions of the Procedure Paper which allow a lessee to show that its non-arm's-length contracts have characteristics "similar to arm's-length contracts which represent fair market value" is merely a restatement of this well-established rule. Thus, under the Procedure Paper appellant does not have an opportunity to attempt to independently establish that its contract price constituted fair market value. Nor is it required to do so. Rather, it is merely afforded an opportunity to establish that the terms of its non-arm's-length contracts are similar to the terms of arm's-length contracts negotiated at the same time in the same general area for the same product. Absent such an affirmative showing, the "yardstick" valuation is properly applied. 5/

In any event, appellant's allegations as to the lack of an opportunity to show that its admitted non-arm's-length contracts were similar to arm's-length contracts are difficult to credit. Appellant raised this point before the Director, MMS, who responded by noting that "Shell had failed to introduce evidence which would establish its contention that its non-arm's-length contracts had characteristics similar to arm's-length contracts." While Shell reiterates its argument before the Board, the record remains devoid of any evidence to support appellant's claim. Appellant has been afforded ample opportunity to submit at least a minimal showing in accord with the Procedure Paper's provisions. Its conclusory allegation of error at this late date can be accorded no weight. Cities Service Oil & Gas Corp., supra at 263.

[7] It is, however, necessary to order one additional modification in the decision below. As noted above, the Procedure Paper provided that in those situations in which the "yardstick" valuation applied, the average value of the "yardstick" for that month would be the minimum value accepted by MMS. However, in Conoco Inc., supra, we rejected use of the average value of the "yardstick," noting that, since the lowest value of the "yard-stick" established a floor price for royalty valuation and such price must, itself, constitute fair market value in order to be acceptable, the floor price rather than the average value of the "yardstick" should be used to recompute the royalty due to the United States. Id. at 244. See also Cities Service Oil & Gas Corp., supra at 263; Union Oil Co., 111 IBLA 369 (1989). We hereby modify the instant decision to conform to this holding.

Appellant has requested oral argument before the Board, pursuant to 43 CFR 4.25. In view of our disposition of the instant appeal, the Board has concluded that oral argument would serve no useful purpose and it is hereby denied.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director, MMS, is reversed to the extent that it ordered use of the "yard-stick" price for non-ethane NGLP's during the period in which their prices

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5/ As a matter of elementary logic, if no contract existed for an inter-affiliate transfer there can be no showing of a similarity with arm's-length contracts.

were subject to DOE control, modified so that the proper "yardstick" price to use in other periods and for ethane generally is the floor price rather than the average price, and remanded for recomputation of the royalties due in accordance with this decision.

James L. Burski
Administrative Judge

I concur:

R. W. Mullen
Administrative Judge